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THE 28th ANNUAL McGRAW-HILL SURVEY OF OVERSEAS OPERATIONS OF U.S. INDUSTRIAL COMPANIES, 1986-87

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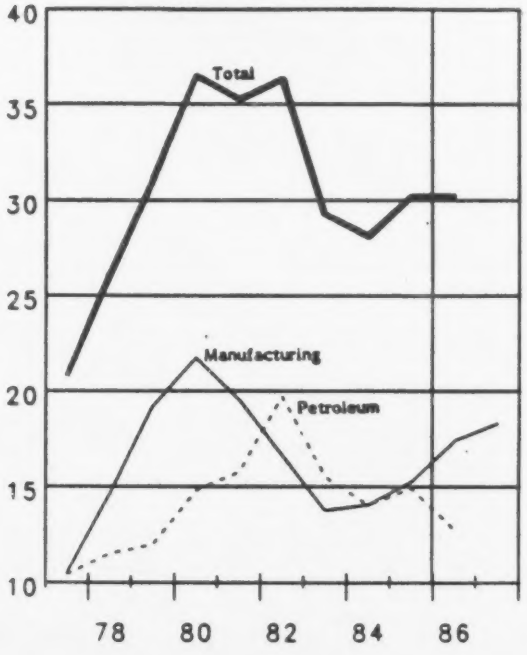
The crosscurrents of falling oil prices, a depreciating dollar, and changing tax policies are reshaping the overseas investment plans of American firms. While petroleum companies are retrenching in the aftermath of a 50% price collapse, manufacturers are raising their commitment to foreign operations. The result is a standoff. According to McGraw-Hill's 28th Annual Survey of Overseas Operations of U.S. Industrial Companies, majority-owned foreign affiliates of U.S. manufacturing and petroleum firms plan to spend $30.2 billion on plant and equipment in 1986, equalling last year's outlays (Table 1 following text). In 1985, capital expenditures rose 7.3%, reversing the downward trend of the early 1980s.

Manufacturing affiliates plan to raise investment abroad 14.0% to $17.4 billion in 1986, followed by a 5.0% increase to $18.3 billion in 1987. In part, the gains represent projects deferred from 1985 budgets. Although the highest in five years, 1986 expenditures fall short of the $21.7-billion peak reached in 1980 (Chart 1).

Chart 1
Overseas Capital Spending
of U.S. Industrial Companies
(Billions of dollars)



In sharp contrast, petroleum companies plan to reduce overseas investment 14.3% to $12.8 billion in 1986, the lowest amount in seven years. This respresents a striking $10.0 billion reduction from the $22.8 billion in capital spending anticipated in last year's survey. The drop in crude oil prices has depressed cash flow and lowered expected returns on exploration and development projects. With all capital programs subject to re-evaluation, petroleum companies were unable to provide estimates of 1987 expenditures.

The upswing in overseas investment by manufacturing firms, concentrated in Europe, is surprising in light of the dollar's sharp depreciation, which puts Europe at a competitive disadvantage. The depreciation has probably increased the dollar prices of plant and equipment purchased in foreign currencies. Thus, the 14% rise in nominal spending might translate into only a minimal a real increase.

The volatility of exchange rates over the past decade has encouraged manufacturers to diversify their sources of supply. By investing in overseas plants, U.S. firms can achieve flexibility in responding to exchange rate fluctuations. If the dollar remains weak, however, companies are expected to shift capital expenditures back to the United States. Thus, the 1986 rise in spending does not signal the beginning of a new trend. Instead, the survey indicates a deceleration in capital outlays in 1987.

From March 1985 to August 1986, the dollar's trade-weighted value against the currencies of 15 industrial nations fell 25%. Over this period, the dollar depreciated nearly 40% against the Japanese yen and the German mark. As a result, labor and capital costs in Europe are significantly higher than in the United States, while Japanese costs have reached parity with U.S. costs. Assuming current tax laws and an exchange rate of 2.05 marks per dollar, German manufacturers now suffer a 39% cost disadvantage relative to U.S. competitors. This disadvantage reflects lower labor productivity, which raises unit labor costs, and less favorable tax treatment of investment, which elevates effective costs of equipment and structures. Whereas Japanese producers enjoyed a 34% average cost advantage over their U.S. counterparts in 1985, the dollar's depreciation (to 155 yen per dollar) has restored cost equilibrium (Chart 2).

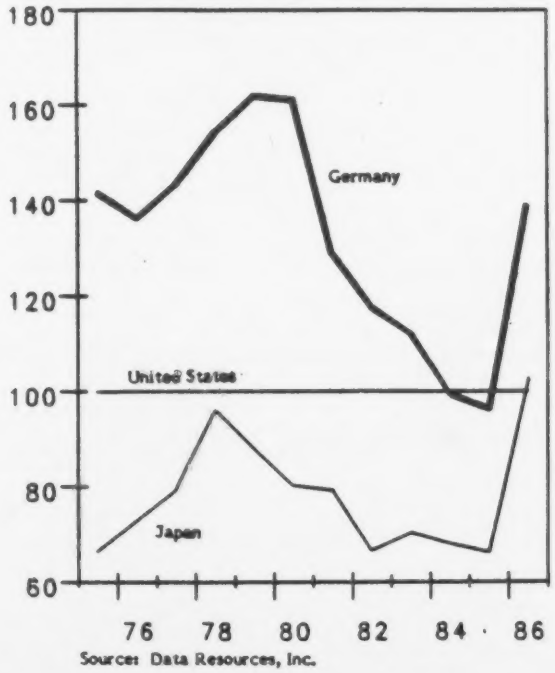
The pending tax reform legislation injects new uncertainty into the capital spending outlook. The elimination of the investment tax credit, a stricter minimum tax, and the weakening of depreciation benefits will raise the cost of capital in the United States,

although by too small a margin to offset the competitive gains resulting from the dollar's depreciation. On the other hand, the reduction in the corporate tax rate from 46% to 34% will encourage foreign affiliates of U.S. companies to repatriate their profits and will reduce the value of foreign tax credits.

In summary, the competitive realignment caused by the dollar's depreciation has lessened the incentives for U.S. firms to invest in facilities in Europe and Japan. Companies are reevaluating their investment strategies in view of exchange rates and proposed changes in the U.S. tax codes. The Latin American and East Asian countries, with weak currencies and cheap labor, represent attractive alternatives to Europe and Japan. The anticipated slowdown in manufacturers' capital spending may signal a waning commitment to overseas operations.

These are the major findings of a survey conducted in July and August among U.S. manufacturing and petroleum companies that account for 18% of U.S. foreign capital spending by majority-owned foreign affiliates. Dollar figures cited in this report represent foreign capital spending by all U.S. industrial firms, not just those companies included in the survey.

Chart 2
Composite Labor and Capital Costs of Foreign Manufacturers As a Percentage of U.S. Costs



Source: Data Resources, Inc.

LATIN AMERICA MAKES A COMEBACK

The geographic distribution of investment flows suggests that U.S. firms are attempting to diversify their supply networks in order to hedge against exchange rate risks. Europe continues to attract the largest share of overseas spending. Manufacturing affiliates in Europe plan to increase capital outlays 23.7% in 1986 and 8.2% (to $10.8 billion) in 1987. The European share of foreign investment by manufacturers will thus climb from 53% in 1985 to 59% next year. Although currency realignments have made European affiliates less competitive in the world market, the economic climate in Europe is improving. Interest rate reductions, tax cuts, and lower oil prices are stimulating domestic demand. In France, the new conservative government is dismantling controls on prices, exchange rates, and credit in an effort to stimulate investment. Europe's very low labor force growth will continue to put upward pressure on wages and encourage firms to invest in more efficient plant and equipment.

Investment in Latin America is making a comeback as the region makes strides toward solving its debt problems. Capital outlays by manufacturing affiliates are expected to rise 28.5% in 1986 and 11.5% in 1987. In an effort to reduce production costs, U.S. auto companies are expanding capacity in Mexico and Brazil. Spending by nonelectrical machinery affiliates will nearly double in 1987 if plans are carried out. While slashing capital budgets in every other region, petroleum companies surveyed plan a fourfold increase in Latin American investments this year.

Latin America is becoming more receptive to foreign investment, recognizing that economic restructuing is the only long-term solution to the debt problem. In a pathbreaking agreement with Mexico, the International Monetary Fund has endorsed a growth-oriented strategy that builds on Treasury Secretary Baker's initiatives. In exchange for new lending, Mexico is commited to liberalize trade, increase non-oil exports, foster foreign and domestic investment, and privatize industry.

Canadian affiliates of U.S. companies plan to reduce plant and equipment spending by 23.0% to $5.6 billion in 1986. While energy investments account for most of the decline, cutbacks are also expected in the machinery, chemicals, food and beverage, and paper industries. The only bright spot is transportation equipment, where U.S. firms plan to boost spending nearly 60%. Petroleum companies plan to trim capital outlays 37.3% to

just $2.6 billion in 1986. The collapse in oil prices has undermined the effectiveness of 1985 policy measures to reduce energy taxes and deregulate oil and gas exports, imports, and prices (the "Western Accord"). Investments in new energy supplies from oil sands and enhanced recovery are no longer profitable.

Despite the region's strong growth prospects, U.S. companies are reducing their already small presence in East Asia. The biggest cutbacks are in petroleum and metals--industries plagued by weak prices. The yen's appreciation is beginning to discourage investment in Japan, while capital controls make investment in Korea difficult. Although Taiwan, Singapore and Hong Kong are receptive to foreign investment, protectionist sentiment in the U.S. Congress may be slowing investment by manufacturing affiliates.

MACHINERY AND TRANSPORTATION EQUIPMENT ARE LEADERS

The 14.0% increase in capital spending by manufacturing affiliates in 1986 is broadly based. The machinery, transportation equipment, and and food industries expect to boost foreign investment by over 20%, while chemical companies and "other" manufacturers plan increases of over 10%. Only the electrical machinery and metal industries will curtail expenditures in 1986. Survey results for 1987 tell a different story. Manufacturers are taking a more cautious attitude toward future spending and nearly all of the rise in capital spending is attributable to producers of nonelectrical machinery. Most other industries will hold investments near 1986 levels.

The primary and fabricated metals group is clearly the weak link in the manufacturing sector. Following an 8.8% drop in 1985, outlays are expected to plunge 29.6% this year and another 3.1% in 1987. Excess worldwide capacity and depressed prices are contributing to the industry's malaise. Companies are still bullish about sales prospects and believe that profit margins have bottomed out, however. The immediate spending reductions are concentrated in Asia, as investment is redirected to affiliates in Canada, Latin America, and Europe.

Ending a four-year decline, investment by the nonelectrical machinery industry should make a strong comeback in 1986 and 1987. Europe and Latin America will be the major beneficiaries, as producers of heavy equipment, engines, and computers add new

capacity. Some of the spending increases represent projects postponed from 1985. Surprisingly, while the machinery industry shows the most aggressive capital spending plans, it is the only industry anticipating lower sales revenues in 1986 and 1987.

Following a 25% surge in 1984, capital outlays by producers of electrical machinery have drifted lower in 1985 and 1986. Apparently the growth of high-tech markets has not met the industry's high expectations. While American firms have focused their investments in Europe, the newly industrialized countries of East Asia have gained a competitive edge with cheap labor. With the industry's profitability improving, companies surveyed expect that capital spending will stabilize next year.

Building on a 31.2% increase in 1985, manufacturers of transportation equipment plan to raise foreign investment 23.7% this year and 3.6% in 1987. Despite strong demand for cars and trucks, intense price competition from new entrants has increased the need for more efficient, labor-saving equipment. Canada will receive a large share of investment dollars, as automakers retool to produce new product lines. U.S. companies are also shifting production to Mexico and other Latin American countries to take advantage of low labor costs.

With lower oil prices boosting profitability, chemical affiliates are planning an 11.5% increase in capital outlays this year and no change in 1987. Producers of industrial chemicals are adding capacity in Europe. Meanwhile, the drug companies are taking a cautious attitude toward spending since the dollar's depreciation has shifted the competitive advantage back to the United States.

Food and beverage companies are stepping up investment in Europe and Australia, while cutting back in Canada. "Other" manufacturers, which include paper, rubber, glass, minerals, and textiles, plan a 10.6% increase in investment abroad in 1986, followed by a 2.6% decline in 1987. Paper companies, in particular, are curtailing investments in Canada.

Table 1
Plans For Capital Spending
(Millions of dollars)

INDUSTRY	1985 ACTUAL	1986 PLANNED	1985-86 % CHANGE	1987 PLANNED	1986-87 % CHANGE
Primary & Fabricated Metals	915.0	644.2	-29.6	624.4	-3.1
Machinery	3,085.0	3,795.7	23.0	4,601.0	21.2
Electrical Machinery	1,426.0	1,399.9	-1.8	1,411.1	0.8
Transportation Equipment	3,265.0	4,038.2	23.7	4,183.7	3.6
Chemicals	2,632.0	2,935.6	11.5	2,929.0	-0.2
Food & Beverages	1,336.0	1,712.3	28.2	1,728.7	1.0
Other Manufacturing	2,592.0	2,867.2	10.6	2,792.5	-2.6
ALL MANUFACTURING	15,251.0	17,393.2	14.0	18,270.5	5.0
Petroleum	14,921.0	12,784.7	-14.3	NA	NA
ALL INDUSTRY	30,172.0	30,177.9	0.0	NA	NA

Table 2
Overseas Capital Expenditures By Regions
(Millions of dollars)

INDUSTRY	CANADA			LATIN AMERICA			EEC*			EUROPE OTHER THAN EEC		
	Estimated	Planned		Estimated	Planned		Estimated	Planned		Estimated	Planned	
	1985	1986	1987	1985	1986	1987	1985	1986	1987	1985	1986	1987
Primary & Fabricated Metals	15	74	99	67	158	142	118	259	245	0	0	0
Machinery	396	231	174	451	510	1,004	1,999	2,580	3,259	0	0	0
Electrical Machinery	135	117	120	78	90	80	875	903	875	39	57	45
Transportation Equipment	761	1,216	1,105	479	683	679	1,715	1,757	1,854	56	44	65
Chemicals	466	385	377	405	407	321	1,272	1,617	1,780	97	120	102
Food & Beverages	405	263	266	95	90	123	644	1,105	1,157	0	0	0
Other Manufacturing	933	697	831	306	477	343	1,183	1,414	1,260	84	141	180
ALL MANUFACTURING	3,111	2,985	2,972	1,880	2,415	2,693	7,807	9,636	10,431	276	363	391
Petroleum	4,152	2,602	NA	553	2,127	NA	2,941	2,052	NA	455	259	NA
ALL INDUSTRY	7,263	5,587	NA	2,433	4,542	NA	10,748	11,688	NA	732	621	NA

INDUSTRY	MIDDLE EAST			AUSTRALIA, NEW ZEALAND, SOUTH AFRICA			JAPAN-ASIA (OTHER THAN MIDDLE EAST)		
	Estimated	Planned		Estimated	Planned		Estimated	Planned	
	1985	1986	1987	1985	1986	1987	1985	1986	1987
Primary & Fabricated Metals	42	61	61	5	27	12	668	64	65
Machinery	18	98	0	83	58	46	137	319	118
Electrical Machinery	0	0	0	9	13	14	290	220	278
Transportation Equipment	0	0	0	197	289	444	55	49	36
Chemicals	4	0	0	98	122	94	227	244	202
Food & Beverages	0	0	0	178	232	177	5	15	0
Other Manufacturing	3	2	0	44	79	95	39	55	83
ALL MANUFACTURING	65	161	61	614	822	882	1,422	966	781
Petroleum	368	211	NA	183	77	NA	2,080	1,602	NA
ALL INDUSTRY	433	372	NA	798	898	NA	3,502	2,568	NA

INDUSTRY	AFRICA (OTHER THAN MIDDLE EAST AND SOUTH AFRICA)		
	Estimated	Planned	
	1985	1986	1987
Primary & Fabricated Metals	0	0	0
Machinery	0	0	0
Electrical Machinery	0	0	0
Transportation Equipment	2	0	0
Chemicals	64	39	53
Food & Beverages	10	7	6
Other Manufacturing	0	0	0
ALL MANUFACTURING	75	46	59
Petroleum	4,189	3,856	NA
ALL INDUSTRY	4,264	3,902	NA

Table 3
Capital Expenditures For Property, Buildings and Equipment
(Percent of total)

INDUSTRY	Estimated 1985			Planned 1986			Planned 1987		
	Property	Buildings	Machinery & Equipment	Property	Buildings	Machinery & Equipment	Property	Buildings	Machinery & Equipment
Primary & Fabricated Metals	0	10	90	0	7	93	0	8	92
Machinery	0	4	96	0	7	93	0	6	94
Electrical Machinery	6	11	83	4	9	87	6	12	82
Transportation Equipment	1	6	93	2	7	90	2	6	92
Chemicals	1	17	82	6	12	82	0	16	83
Food & Beverages	0	21	79	0	19	81	0	22	78
Other Manufacturing	3	18	78	6	23	71	1	11	88
ALL MANUFACTURING	1	9	90	3	9	88	1	8	91
Petroleum	0	0	100	0	0	100	NC	NC	NC
ALL INDUSTRY	1	8	91	2	9	88	1	8	91

Table 4
Expected Profit Margins On Sales
Overseas Subsidiaries vs. U.S.

INDUSTRY	1986 % of Companies Answering			1987 % of Companies Answering		
	Higher	Lower	Same	Higher	Lower	Same
Primary & Fabricated Metals	0	60	40	0	60	40
Machinery	50	50	0	50	50	0
Electrical Machinery	20	60	20	20	60	20
Transportation Equipment	0	100	0	0	100	0
Chemicals	56	33	11	33	44	22
Food & Beverage	0	50	50	0	50	50
Other Manufacturing	71	29	0	67	33	0
ALL MANUFACTURING	33	50	17	26	54	20
Petroleum	25	50	25	33	33	33
ALL INDUSTRY	33	50	17	26	53	21

Table 5
Expected Overseas Profit Margins On Sales
1986 vs. 1985, 1987 vs. 1986

INDUSTRY	---1986 vs. 1985--- % of Companies Answering Higher	Lower	Same	---1987 vs. 1986--- % of Companies Answering Higher	Lower	Same
Primary & Fabricated Metals	20	20	60	40	0	60
Machinery	100	0	0	100	0	0
Electrical Machinery	80	20	0	100	0	0
Transportation Equipment	50	50	0	100	0	0
Chemicals	78	0	22	56	11	33
Food & Beverage	0	0	100	0	0	100
Other Manufacturing	71	14	14	67	17	17
ALL MANUFACTURING	58	14	28	62	6	32
Petroleum	0	100	0	50	0	50
ALL INDUSTRY	53	23	25	61	6	33

Table 6
Expected Sales Of Foreign Affiliates

	1985-86	1986-87
Primary and Fabricated Metals	15.1	16.1
Machinery	-5.8	-1.2
Electrical Machinery	13.0	8.1
Transportation-Equipment	21.3	8.1
Chemicals	7.7	7.5
Food & Beverages	16.1	10.7
Other Manufacturing	13.3	8.9
TOTAL MANUFACTURING	13.9	7.3